No. 419.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1939.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

JOHN KEHOE.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

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INDEX.

INDEX OF CASES CITED.

INDEX OF STATUTES AND MISCELLANEOUS AUTHORITIES CITED.

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Guy T. Helvering, Commissioner of Internal Revenue, Petitioner,

v.

John Kehoe.

BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

The respondent respectfully submits this brief in opposition to the petition for *certiorari* herein on behalf of Guy T. Helvering, Commissioner of Internal Revenue, petitioner.

QUESTIONS PRESENTED.

Where a taxpayer files his income tax return for 1925 without accounting therein for alleged taxable

income from the illegal operation of a brewery, and thereafter the Commissioner of Internal Revenue, upon the basis of an investigation and report to him by his representative, determined an additional net income of $53,990.46, upon which tax was assessed and paid and a closing agreement entered into, and later the Commissioner seeks to set aside the closing agreement on the ground that brewery income had not previously been taxed;

(1) Is the ultimate finding by the Board of Tax Appeals of fraud or malfeasance or misrepresentation of fact in the closing agreement, a conclusion of law, or at least a determination of a mixed question of law and fact, which is subject to judicial review, and upon which the Circuit Court may substitute its judgment for that of the Board; and

(2) May the Circuit Court properly hold as a matter of law, that the ultimate fact of fraud or malfeasance or misrepresentation of fact in the closing agreement, is unsupported by any substantial evidence, when the Commissioner, upon whom the statute imposed the burden of proof, called no witnesses and presented no evidence, which he could have produced, as to the nature or source of the additional income covered by the closing agreement, whether from the brewery or elsewhere, or as to how he determined same, or as to taxpayer's conduct or participation in the matters connected with the closing agreement.

STATEMENT OF THE CASE.

Taxpayer has determined to write his own statement because the petition for *certiorari* contains misstatements, as well as statements tending to mislead this Court. Examples of such appear below.

On page 13, paragraph 11, petitioner asserts that; "The **net** income derived from illegal operations of the brewery was $890,000." This statement does not accord with the Board's findings and is not supported by the evidence. Petitioner alleged in his deficiency notice and pleadings that the $890,000 was gross receipts from brewery operations (R. 16, 22, 23). The Board found **gross** receipts from the operation of the brewery in excess of $890,000 (R. 49, 50, 52). The cost of operations was not considered and nowhere is there any testimony or any finding that the $890,000 is **net** income.

On page 15, petitioner asserts "that he [taxpayer] made payments to McGowan after 1927 to insure his continued silence", but the Court will search the record in vain for any proof thereof. No facts were found by the Board or set up in the petition which would support this statement.

On page 6, petitioner infers that the first information he had with regard to any income from the brewery was through information furnished by McGowan and others in June, 1929. The expression "first information" is found in the claim for reward executed March 29, 1932, where it appears in the matter printed by the Treasury Department on the

blank form which it furnishes for use in making claim (Exhibit 1). There is no evidence in the record showing that this was petitioner's first information of brewery income.

The taxpayer submits the following as the statement of the case.

As stated by the Circuit Court in its opinion, "The fact situation presents no dispute" (R. 493).

Taxpayer's return for 1925 filed March 15, 1926, showed gross income of $27,865.61 and a net taxable income of $19,198.33 on which tax was paid (Ex. LLL and R. 10, 11, 19, 20, 43). As a result of investigation and report by his agents in September, 1927, the Commissioner increased taxpayer's net taxable income to $73,188.79, an increase of $53,990.46 upon which taxpayer paid additional tax and interest of $10,437.18 (R. 10, 11, 19, 43, 44). Thereafter on January 27, 1928, taxpayer and Commissioner, pursuant to Section 1106(b) of the Revenue Act of 1926, agreed in writing, approved by the Acting Secretary of the Treasury, that taxpayer's liability for 1925, as then determined, should be final and conclusive (R. 11, 12, 19, 20, 44-46).

On February 24, 1932, Commissioner notified taxpayer that the closing agreement had been set aside (R. 17) and that he had determined a deficiency in tax for 1925 of $208,043.36, plus a 50% fraud penalty of $108,803.61 based on income in the amount of $890,000 from the operation of a brewery (R. 15-17). The Commissioner's statement of the deficiency (R. 16) showed that the $890,000 embraced the addi-

tional income of $53,990.46 covered by the closing agreement. Taxpayer petitioned the Board of Tax Appeals for a redetermination of this deficiency (R. 8-17).

The Board found that the Commissioner had established taxpayer's connection with the brewery in 1925 and that no income therefrom had been accounted for in his original return for that year. The Commissioner had alleged in his answer to taxpayer's petition for redetermination, that one W. F. Loughran had paid $890,000 in that year to taxpayer for cereal beverage purchased by him from the taxpayer, but this was not proved as Loughran refused to so testify when called as a witness by Commissioner (R. 23, 462, 472). The income of $890,000 disclosed by the evidence as found by the Board represented "gross receipts" from sales of beer (R. 50, 52).

Upon the issue made by the pleadings, whether the taxpayer had additional taxable income beyond the $53,990.46 covered by the closing agreement (R. 20-26, 27), the Commissioner, although his agents had investigated and reported on the additional taxable income covered by the agreement, did not call his agents as witnesses, or present their report, or otherwise attempt to show the nature or source of the additional income covered by the closing agreement, whether from the brewery or elsewhere, or how he determined same before entering into that agreement, or taxpayer's conduct or participation in the matters connected with the closing agreement.

The Board concluded that the Commissioner had sustained his burden of proving fraud or malfeasance or misrepresentation of fact in the closing agreement and was justified in setting it aside (R. 44, 50).

On this issue the Circuit Court reversed the Board, saying:

> "As the proofs stood, and now stand, we are of opinion the government has not made out its case. There is no ground of proven fact to support a finding that the now alleged brewery liability was not included in the settlement, in the $53,000 additional gross income of Kehoe. There is no proof of any other alleged liability on the part of Kehoe which led to this large addition. It will be noted that the Tax Board nowhere considered or discussed the two underlying, basic and important questions—first, what tax liability was considered and involved in the settlement made in pursuance of the revenue officer's examination. Second, on what liability, if not for the brewery, was the additional $53,000 predicated? And lastly, and all important, the failure of the government to call its agent and show by him, if it could, that the brewery liability was not involved in the settlement" (R. 497).

REASONS FOR REFUSING THE WRIT.

1. The court below did not usurp the jurisdiction of the Board of Tax Appeals.

Petitioner, as ground for granting the writ of *certiorari*, charges that the court below has so far

departed from the accepted and usual course of judicial proceeding as to call for an exercise of this Court's power of supervision. Specifically, petitioner charges that the court below ignored substantial evidence supporting the Board's finding of fact and usurped the jurisdiction of the Board by weighing the evidence and substituting its own finding for that of the Board.

This charge is unfounded. What the court below did was to determine from the record whether there was any substantial evidence to support the finding of the Board that brewery income was omitted from the closing agreement through fraud or malfeasance or misrepresentation.

Whether there was any substantial evidence to support the ultimate finding of the Board is clearly a question of law, or at least a determination of a mixed question of law and fact, which is the subject of judicial review, and on such review the court may substitute its judgment for that of the Board.

Colorado Bank v. Commissioner, 305 U. S. 23 (1938);

Bogardus v. Commissioner, 302 U. S. 34, 38 (1937);

Helvering v. Tex-Penn Co., 300 U. S. 481 (1937).

It is clear that the court below, in searching the record to determine whether there was substantial evidence to support the ultimate finding of the Board,

was properly exercising its jurisdiction as defined by this Court and was not usurping the functions of the Board, as charged by petitioner.

It is difficult to understand the basis of petitioner's serious charge against the court below that it abused its powers in deciding that the record lacks substantial evidence of the omission of brewery income from the closing agreement, when he now admits (petition page 5) that **"The nature of the additional income of $53,990.46 on which the deficiency was based is not disclosed by the record"**. It may be that the petitioner seeks thereby to distract this Court's attention from the unfavorable presumption which, by law, attends his failure to produce the direct and explicit evidence in his possession (his agent's report, for example) of the nature and source of the income on which the additional tax was assessed and paid and the case closed in 1928.

2. There was no substantial evidence to support the ultimate finding of the Board that there was fraud or malfeasance or misrepresentation of fact in the execution of the closing agreement.

The court below reversed the Board of Tax Appeals upon the issue of fraud or malfeasance or misrepresentation of fact materially affecting the determination and assessment of the tax covered by the closing agreement, and rightly so, we contend, because the Board's ultimate finding was not supported by substantial evidence.

On this issue the Commissioner, petitioner here, had the burden of proof by statute.

Revenue Act of 1926 (Act of February 26, 1926, c. 27, 44 Stat. 9, 113, See: 26 U. S. C. A. 1660(b));

Revenue Act of 1928 (Act of May 29, 1928, c. 852, 45 Stat. 872, 26 U. S. C. A. 612);

Jones v. Simpson, 116 U. S. 609, 615 (1886).

What is substantial evidence upon an issue of fraud? Not inference or presumption, nor even a bare preponderance which leaves the issue in doubt, but only that which is **clear, unequivocal and convincing,** and, of course, the best evidence of which the nature of the case will admit.

United States v. American Bell Telephone Co., 167 U. S. 224 (1897);

Farrar v. Churchill, 135 U. S. 609 (1890);

Colorado Coal and Iron Co. v. United States, 123 U. S. 307 (1887);

Maxwell Land-Grant Case, 121 U. S. 325 (1887);

Jones v. Simpson, supra;

United States v. Arredondo, 6 Peters 691, 21 U. S. 689 (1832);

Griffiths v. Commissioner, 50 Fed. (2d) 782 (C. C. A. 7, 1931);

Budd v. Commissioner, 43 Fed. (2d) 509 (C. C. A. 3, 1930);

Kerbaugh v. Commissioner, 29 B. T. A. 1014 (1934).

Confronted with the closing agreement, which he had made with the taxpayer in 1928, and which, *prima facie*, finally and completely settled all controversies between them in respect of the 1925 tax liability[1], the Commissioner could sustain his burden only by proving clearly and convincingly that the additional income of $53,990.46 covered by the closing agreement, did not include respondent's taxable income from the brewery.

However, the Commissioner admits (petition, page 5) that "The nature of the additional income of $53,990.46 on which this deficiency was based is not disclosed by the record." And why was this not disclosed? Because the Commissioner, while admitting (R. 19)

> "* * * that about the month of September 1927 a representative of the Bureau of Internal Revenue made an investigation of the income tax liability of said petitioners for the year 1925; * * * that the report of the investigation was prepared and forwarded to respondent at Washington, D. C., on about September 19, 1927, * * * that the report showed a total tax liability (inclusive of the amount shown on the aforesaid return) of $9,758.42 for said year or an additional tax for said year of $9,563.86; * * * that in the computation of such additional tax liability the representatives of the Bureau of Internal Revenue increased the taxable income for 1925 from $19,198.33 as shown by the aforesaid return to $73,188.79; * * *"

[1] Wolverine Petroleum Corporation v. Commissioner, 75 Fed. (2d) 593 (C. C. A. 8, 1935).

for some reason, as yet unexplained, did not call his investigating agent as a witness, or present his report, or otherwise attempt to show the nature or source of the additional income covered by the closing agreement, whether from the brewery or elsewhere, or how he determined same before entering into that agreement, or taxpayer's conduct or participation in the matters connected with that agreement.

Logically this was the primary and best evidence of which the nature of the case would admit and it was within petitioner's power to produce it. Less satisfactory evidence is neither clear, unequivocal and convincing, nor substantial evidence "such * * * as a reasonable mind might accept as adequate to support a conclusion."

Consolidated Edison v. N. L. R. B., 305 U. S. 197, 229 (1938).

Indeed, the absence of the primary evidence, not accounted for, raises a presumption that, if produced, would give a complexion to this case adverse to the interest of the petitioner.

Clifton v. United States, 45 U. S. 242, 4 How. 242 (1846);

Runkle v. Burnham, 153 U. S. 216 (1894);

Caminetti v. United States, 242 U. S. 470 (1917);

Bilokumsky v. Tod, 263 U. S. 149 (1923);

Mammoth Oil Co. v. United States, 275 U. S. 13 (1927);

Interstate Circuit, Inc. v. United States, 306 U. S. 208 (1939).

Nor is the petitioner here, an officer of the government, having the burden of proof, any less susceptible to the unfavorable presumption which arises from failure to produce the best evidence in his power, than the ordinary litigant.

Lau Hu Yuen v. United States, 85 Fed. (2d) 327 (C. C. A. 9, 1936).

Petitioner attempts to circumvent his failure to put his witnesses on the stand to prove the nature of the income covered by the closing agreement by arguing:

(1) That the first information he received of the brewery income was from McGowan and Jones;

(2) That taxpayer concealed the brewery income after the execution of the closing agreement; and

(3) That taxpayer denied any connection with the brewery in his pleadings in this case.

(1). Petitioner's argument that, since McGowan and Jones did not come to him with detailed information about taxpayer's interest in the brewery until after the closing agreement, petitioner did not have knowledge of it until the time, is a *non sequitur*. It does not show that petitioner did not have knowledge of the source of the taxpayer's income from his own investigation in 1927 and did not base the closing agreement on income from such source.

In:

26 C. J. Sec. 75, 1163,

it is stated:

> "Where the representee undertakes an independent investigation he is ordinarily chargeable with knowledge of all the facts which such an investigation should disclose, * * *."

The fact that McGowan and Jones may have given the petitioner more detailed information on the brewery operation, the income from which was already known to petitioner, is insufficient ground to charge the taxpayer with fraud and misrepresentation regarding the execution of the closing agreement covering income from that source. Other proof is necessary and it was not forthcoming.

There is no evidence in this record showing that petitioner failed to disclose income received by him from the brewery at the time the closing agreement was executed. There is no evidence that the first information concerning the operations of the brewery came to petitioner subsequent to the execution of such agreement. The only mention of "first information" in the record comes from the printing on the Treasury form used in making claim for reward and this is no evidence whatsoever. (Exhibit No. 1.)

On the contrary, the deficiency notice, admittedly sent to taxpayer on February 24, 1932 (R. 15-17), shows that the alleged income from the brewery in

the sum of $890,000 includes in it the additional income of $53,990.46 on which the assessment of 1927, covered by the closing agreement, was based. In the deficiency notice (R. 16-17), petitioner adopts from the taxpayer's original tax return as "net income reported," the figure of $19,198.33, adds to this as "other income not reported from operation of the P. F. McGowan Brewery of Edwardsville, Pa.," the amount of $890,000, and as "corrected net income" takes the total of these two items, $909,198.33. This notice shows "tax previously assessed, original $194.56" which is the tax on $19,198.33, the net income originally reported. It also shows "tax previously assessed, additional $9,563.86," which is the deficiency paid in 1927 on an increase in income of $53,990.46, included in the closing agreement. Since this additional income of $53,990.46 is not specifically and separately referred to in the notice, it must be included in the $890,000 designated as income from the brewery. In the light of this and in the absence of any evidence to the contrary produced by the petitioner, it must be assumed that he knew, at the time he entered into the closing agreement with the taxpayer, that this additional taxable income of $53,990.46 had come from the operation of the brewery.

The fact that the present assessment is on an additional income of $890,000 and the assessment of 1927 was on an added income of only $53,990.46, does not prove that this is not the same income, because the $890,000 is gross receipts from the brewery (R. 22.

23, 50, 52) with no deductions for the costs of operation, whereas the $53,990.46 is net taxable income, and for all that appears in this record is the net taxable income of taxpayer from his interest in the brewery.

(2). Petitioner argues that concealment by the same devices as previously employed continued until long after the 1927 closing agreement, and that taxpayer made payments to McGowan after 1927 to assure his continued silence.

The only testimony showing payments to McGowan to insure his silence, which will be found by examination of the petitioner's record references, covered occurrences before February 28, 1927, at which time McGowan's connection with the brewery ceased (R. 173). For example, the purchase of an automobile to send McGowan away on a trip, instructions to keep his mouth shut, and an injunction to deceive McQuade as to the true ownership of the brewery, all occurred prior to February 28, 1927.

With regard to taxpayer's alleged promise to pay McGowan $60,000, or $70,000, this was first made in 1925 (R. 210). The reason for the payment was for the "rap" McGowan thought he would have to take (R. 211) and for the investigation he had to undergo (R. 212). These promises related to occurrences in 1925. The only other testimony concerning the same sum of money was that of McGowan who testified that taxpayer, on the Friday before April 19, 1928, had promised to pay him that amount, if he

had to go to jail for violation of the National Prohibition Act (R. 221). It was to protect McGowan's wife and children and not to insure silence (R. 221). This is borne out by the fact that, when the court decided that he did not have to go to jail, taxpayer did not make the payment to him.

(3). Petitioner argues that taxpayer's denial in the pleadings that he ever received any income from the operation of the brewery in 1925 indicates that income from the brewery was not included in the closing agreement.

However, this does not follow, for the taxpayer in the pleadings also expressly refused to concede the correctness of the income forming the basis of the closing agreement (R. 10). In other words, both as to the assessment covered by the closing agreement and the present assessment, taxpayer denied that there was any additional income which he received for 1925, but in each case the petitioner thought differently. Therefore, a denial of receipt of income from the operation of the brewery does not indicate that the closing agreement did not cover such income.

Furthermore, the pleadings in this case raised two distinct issues, first, was there fraud or misrepresentation in connection with the closing agreement, and second, was the original return false and fraudulent. The facts supporting both these issues were pleaded affirmatively by petitioner in his answer and in order to frame these issues, as required by the rules of the

Board, taxpayer in his reply made appropriate denials. To meet the facts which petitioner averred supporting the issue of fraud relating to the closing agreement, the taxpayer denied that he had received any income in 1925 in addition to that covered by the closing agreement, or that any such income had been concealed from petitioner. In meeting the issue of a false return, taxpayer denied the receipt of any income from the brewery.

It is a well settled principle of evidence that a party is forbidden to resort to his adversary's pleadings on one issue in a cause to prove another issue in the same cause.

2 Wigmore on Evidence, Sec. 1064(2).

As stated by Mansfield, *C. J.*, in:

Harington v. MacMorris, 5 Taunt. 228, 233 (1813):

"* * * it is every day's practice, that the defendant's language in one plea cannot be used to disprove another plea, as in the familiar instance I have given of trespass, and not guilty and a justification pleaded, where the justification would certainly, if admissible, prove the act, in case the reason of the justification fails. * * *"

Moreover, the denial in the pleadings upon which petitioner bases his argument is a pleading only. It was not offered in evidence and, therefore, has no evidential value. If petitioner had offered this denial in evidence, it would have been evidence against him

on the issue whether the original return was false. Since petitioner did not take the risk of offering this adverse testimony on this issue, he should not now be allowed to use it on the other issue.

In addition, taxpayer's denial in the pleadings of any connection with the brewery is not necessarily inconsistent with the conclusion that the additional income taxed in 1927 was in fact net income from the brewery. The taxpayer might very well have consented to the taxability of the brewery income in connection with the execution of the closing agreement and still have been reluctant to admit his connection with the brewery in a formal document open to public inspection, such as the pleadings in this case. This is especially true in view of the fact that, although compelled to pay tax on his income regardless of source, he is not required to make admissions which might incriminate or degrade him.

United States v. Sullivan, 274 U. S. 259 (1927); Steinberg v. United States, 14 Fed. (2d) 564 (C. C. A. 2, 1926).

The tenuous arguments of petitioner lack conviction and leave unanswered the question as to why he did not produce the best evidence in his power. This is the vital factor which cuts clearly across all else in petitioner's case. The conclusion is inescapable that such evidence (his agent's report, for example) was adverse to petitioner's own interest, or he would have used it.

As the court below so aptly stated (R. 498):

> "When the government is a litigant, it stands on the same basis as any other litigant and it is clear to us that if this was a case between private persons and one party was seeking to set aside a settlement made by the parties, he could not succeed where the failure to furnish was such as in the present case."

CONCLUSION.

The situation which petitioner seeks to overcome may be stated as follows: Assume that taxpayer's original return was false and fraudulent, and that taxpayer withheld income which he should have returned. Petitioner made an independent investigation, found the additional income, taxed it, and then made a closing agreement, taxpayer having paid the additional tax.

Prima facie, this closing agreement is valid and was entered into with full knowledge of all relevant facts, especially those facts which an investigation such as was made should have or did disclose. Therefore, *prima facie,* the closing agreement included all taxable income not reported originally and included the net income from the brewery which petitioner now seeks to redetermine and assess. If the facts are otherwise, the burden was on the petitioner to so prove.

The petitioner failed to meet this burden. Admittedly he produced no evidence to show his knowledge of the additional income determined in 1927 or the nature or source thereof. Although the facts disclosed by his independent investigation were known to petitioner and must have shown the nature and source of the additional income of $53,990.46, upon which the additional tax and interest of $10,437.18 was assessed and paid, and constituted the best available evidence on the issue, petitioner neither produced the report of the revenue agents who made the investigation, nor summoned them as witnesses.

Neither the petitioner, nor his agents testified, that at the time the final closing agreement was executed, they lacked knowledge that the taxpayer had received income from the brewery operations, or that the taxable income on which the closing agreement was based did not include net income therefrom.

In the absence of such direct and explicit evidence, which petitioner could have produced, the court below properly reversed the board and it is respectfully submitted that the petition for a writ of *certiorari* should be denied.

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